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No. 90-1830

In The

Supreme Court of the United States

October Term, 1990

BOYD COUNTY BOARD OF EDUCATION,

Petitioner,

vs.

UNITED STATES FIDELITY & GUARANTY CO.,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Sixth Circuit

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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June, 1991

QUESTIONS PRESENTED FOR REVIEW

1. Should a school board which contributed money to a county government for the completion of a school building owned by the county government be permitted to amend its Complaint to seek recovery of that money from the bonding company of the allegedly defaulting prime contractor on the theory of equitable subrogation?

2. Did the Court of Appeals err by affirming the decision of the District Court without opinion?

3. Did the District Court err in concluding that a school board which contributed money to a county government to complete the construction of a school building owned by the county government was a volunteer in so contributing?

4. Did the District Court, on the Petitioner's Motion for Leave to Amend its Complaint, err in concluding that principles of equity did not entitle the Petitioner to amend its Complaint to assert the equitable remedy of equitable subrogation?

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED FOR REVIEW i

TABLE OF CONTENTS ii

TABLE OF AUTHORITIES iv

STATEMENT OF THE CASE 1

SUMMARY OF THE ARGUMENT 4

ARGUMENT

I. THE PROCEEDINGS BELOW DID NOT DEPART FROM THE ACCEPTED AND USUAL COURSE OF JUDICIAL PROCEEDINGS SO AS TO CALL FOR THIS COURT'S POWER OF SUPERVISION 5

II. THE DISTRICT COURT'S DISMISSAL OF THE PETITIONER'S ORIGINAL COMPLAINT WAS CORRECT 6

III. THE DISTRICT COURT WAS CORRECT IN DENYING THE SCHOOL BOARD LEAVE TO AMEND 7

A. THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN DENYING THE SCHOOL BOARD LEAVE TO AMEND .. 7

B. THE SCHOOL BOARD IS NOT ENTITLED TO ASSERT A CLAIM BASED UPON THE THEORY OF EQUITABLE SUBROGATION 11

TABLE OF CONTENTS – Continued

Page

1. THE SCHOOL BOARD'S CONTRIBUTION OF MONEY TO THE FISCAL COURT'S CONSTRUCTION FUND WAS VOLUNTARY..... 12

2. THE NEW SUPPLIERS OF LABOR AND MATERIALS TO WHOSE RIGHTS THE SCHOOL BOARD CLAIMS TO BE SUBROGATED ARE NOT PROTECTED BY THE USF&G BOND..... 14

IV. THE DISTRICT COURT'S STAY OF THIS ACTION WAS NOT ERROR AND DID NOT PREJUDICE THE SCHOOL BOARD..... 16

V. THE COURT OF APPEALS COMMITTED NO ERROR IN AFFIRMING THE DECISION OF THE DISTRICT COURT WITHOUT LENGTHY OPINION.....19

CONCLUSION 21

APPENDIX

A. APRIL 26, 1990 MEMORANDUM OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT, EASTERN DISTRICT OF KENTUCKY..... App. 1

B. MARCH 13, 1990 MAGISTRATE'S REPORT AND RECOMMENDATION..... App. 11

C. FEBRUARY 26, 1991 PER CURIAM OPINION OF THE UNITED STATES COURT OF APPEALS, SIXTH CIRCUIT..... App. 16

TABLE OF AUTHORITIES

Page

CASES:

Bryan v. Henderson Electric Company, Ky. App., 566 S.W.2d 823 (1978) 12

City of Jackson v. First National Bank of Jackson, 289 Ky. 1, 157 S.W.2d 321 (1941) 13

National Surety Corporation v. Allen-Codell Co., 70 F. Supp. 189 (E.D. Ky. 1947) 8, 12

Petroleum Exploration, Inc. v. Public Service Commission of Kentucky, 304 U.S. 209 (1938) 9, 10

Pierce v. Underwood, 487 U.S. 552 (1988) 17

Salve Regina College v. Russell, 499 U.S. ___, 111 S. Ct. 1217, 113 L.Ed.2d 190 (1991) 19, 20

United Pacific Insurance Company v. First National Bank, Ky., 457 S.W.2d 833 (1970) 8

United States v. Wood, 877 F.2d 453 (6th Cir. 1989) 8

Vance v. Atherton, 252 Ky. 591, 67 S.W.2d 968 (1934) 8, 13

W. T. Grant Co. v. Indian Trail Trading Post, Inc., Ky., 438 S.W.2d 91 (1968) 9

Western Casualty & Surety Co. v. Meyer, 301 Ky. 487, 192 S.W.2d 388 (1946) 9

York v. Cline Construction Co., Ky., 336 S.W.2d 234 (1960) 12

RULES:

Federal Rules of Appellate Procedure Rule 36 20

Federal Rules of Civil Procedure 15(a) 8, 10

United States Supreme Court Rule 15.1 1

STATEMENT OF THE CASE

Due to a number of misstatements of fact contained in the Petitioner's Statement of the Case, the Respondent submits the following Statement of the Case pursuant to Rule 15.1.

On or about August 1, 1984, the Boyd County Fiscal Court ("Fiscal Court"), the legislative body of Boyd County, Kentucky, entered into a contract with Philip Diniaco and Sons, Inc. ("Diniaco"), a West Virginia construction company, for the construction of certain additions and alterations to the Boyd County High School in Cannonsburg, Kentucky ("the Project"). On September 5, 1984, Diniaco and the Respondent, United States Fidelity & Guaranty Co. ("USF&G"), executed a Performance and Payment Bond for the protection of the Fiscal Court as owner of the Project.[1]

In the summer of 1986, the relationship between Diniaco and the Fiscal Court deteriorated to the point that Diniaco was compelled to cease work and leave the job site. The Petitioner erroneously states in its Petition that Diniaco "abandoned the job after drawing most of the contract funds," misleading the Court to believe that

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[1] USF&G is a wholly owned subsidiary of United States Fidelity and Guaranty Corp. USF&G owns twenty-two percent (22%) of Capital Guaranty Corporation and twenty-four percent (24%) of Capital Re Corporation.

Diniaco was at fault for the litigation arising from the construction Project. Diniaco filed suit in the United States District Court, Eastern District of Kentucky, Civil Action No. 86-107, claiming breaches of contract, and the Fiscal Court filed a Counterclaim. That civil action is hereinafter referred to as "the action on the contract." The Fiscal Court then hired a new general contractor and engaged new subcontractors, all at significantly higher costs than the contract with Diniaco had provided. Petitioner erroneously states that the "county as owner took over the job," misleading the Court to believe that the Fiscal Court's role somehow changed from owner to contractor.

In February of 1987, the Fiscal Court and the Petitioner, Boyd County Board of Education ("School Board"), filed this action against USF&G seeking to collect on the September 5, 1984 bond. This action was removed to the United States District Court, Eastern District of Kentucky, Civil Action No. 87-72. This action is hereinafter referred to as "the action on the bond."

Throughout the proceedings in the action on the contract, the School Board ardently disclaimed any ownership interest in the Project, and maintained that it was not a party to the construction contract, that it bore no responsibility for the problems associated with the Project, and that Diniaco had dealt with it "at its own peril." The District Court granted the School Board's Motion to Dismiss it as a party to the action on the contract, based upon a finding that the Fiscal Court was the owner of the project and not the School Board.

The action on the bond was held in abeyance by the District Court in May of 1987, pending a determination of liability in the action on the contract. The action on the contract was ultimately settled between Diniaco and the Fiscal Court, and the action was dismissed with prejudice on May 17, 1989, thereby fully and forever settling all of the claims of Diniaco against the Fiscal Court, and vice versa.

The Fiscal Court agreed to dismiss its Complaint against USF&G in this action, but the School Board refused. Because of the School Board's refusal, USF&G moved the District Court to dismiss the Complaint in this action on the bond. Apparently recognizing that its Complaint was deficient, the School Board filed a Motion for Leave to Amend its Complaint in order to allege a claim based upon principles of equitable subrogation. As grounds for its Motion to Amend, the School Board alleged that it provided money to the Fiscal Court in the amount of $725,467.80 so that the Fiscal Court could complete the Project. USF&G opposed the School Board's Motion for Leave to Amend its Complaint.

On March 13, 1990, the United States Magistrate to whom the matter had been referred issued his Report and Recommendation to the District Court, specifically recommending that the School Board's Motion to Amend its Complaint be denied and that USF&G's Motion to Dismiss the original Complaint be granted. On April 26, 1990, the District Court issued its Memorandum Opinion and Order, denying the School Board's Motion to Amend its Complaint and granting USF&G's Motion to Dismiss the original Complaint. The School Board immediately appealed the District Court's decision to the United

States Court of Appeals for the Sixth Circuit, which affirmed the District Court on February 26, 1991. The Petitioner's Petition for Writ of Certiorari followed.

SUMMARY OF THE ARGUMENT

The School Board was never a beneficiary of the USF&G Bond because it was neither the owner of the Project, nor a supplier of labor or materials under the contract between Diniaco and the Fiscal Court. Consequently, the School Board's original Complaint which claimed that the School Board was protected by the USF&G Bond could not withstand a Motion to Dismiss, and the District Court correctly dismissed the Complaint.

The District Court properly denied the School Board's Motion for Leave to File an Amended Complaint which sought recovery against the USF&G Bond on the theory of equitable subrogation. The School Board's Tendered Amended Complaint could not have withstood a Motion to Dismiss because (1) the inconsistency of the School Board's positions in this action and in the previously concluded action caused the balance of equities to be against the School Board, (2) the School Board's contribution to the Fiscal Court was voluntary and (3) those to whose rights the School Board sought to be subrogated held no rights against USF&G or Diniaco under the USF&G Bond.

The District Court's stay of this action pending the outcome of the liability issues in the action on the contract was an appropriate exercise of the Court's discretion in controlling its docket. The stay did not prejudice the

School Board because nothing occurred after the stay was implemented which affected the rights of the School Board. The School Board's original Complaint could not have withstood a Motion to Dismiss at the time of filing or thereafter, and the facts causing the District Court to deny the School Board's Motion for Leave to Amend existed at the time the District Court stayed this action.

The School Board's argument that the Sixth Circuit Court of Appeals' decision affirming the District Court's Order should be reversed because the Court of Appeals issued only a two paragraph per curiam opinion is simply meritless. The School Board cites no authority for its proposition, and, in fact, the Federal Rules of Appellate Procedure specifically contemplate judgments of the Court of Appeals without opinion.

ARGUMENT I

THE PROCEEDINGS BELOW DID NOT DEPART FROM THE ACCEPTED AND USUAL COURSE OF JUDICIAL PROCEEDINGS SO AS TO CALL FOR THIS COURT'S POWER OF SUPERVISION.

The Petitioner asserts four errors by the lower Courts, three by the District Court and one by the Court of Appeals, the combination of which, Petitioner asserts, resulted in the Petitioner becoming "persona non grata" in the Federal Court system. (Petition, p. 6). Because the Petitioner has been unable to find a substantive reason for review by this Court, it now claims that its loss below is the result of proceedings "so far depart[ing] from the accepted and usual course of judicial proceedings as to call for this Court's power of supervision." (Petition, p.

7). Substantively, the Petitioner's arguments on this Petition for Writ of Certiorari are identical to those raised at the District Court and at the Court of Appeals, with the additional allegation of error in the Court of Appeals' Order affirming the District Court without opinion. The Respondent submits that the District Court and the Court of Appeals acted at all times within their discretion. Certainly neither Court deviated "so far from the accepted and usual course of judicial proceedings" as to call for this Court's intervention.

ARGUMENT II

THE DISTRICT COURT'S DISMISSAL OF THE PETITIONER'S ORIGINAL COMPLAINT WAS CORRECT.

The School Board argues that the District Court erred in dismissing its original Complaint against USF&G. The School Board and the Fiscal Court originally sought to recover directly against USF&G as beneficiaries under the USF&G Bond, which was entered into between USF&G and Diniaco for the protection of the Fiscal Court as owner of the Project, and for the protection of the suppliers of labor and materials under the contract between the Fiscal Court and Diniaco. The School Board was not the owner of the Project, and it was not afforded any protection by the USF&G Bond. In fact, the School Board vigorously and successfully argued in the action on the contract that it was not the owner of the Project. Because the School Board was not the owner of the Project or a beneficiary under the bond, its Complaint seeking to recover directly against the bond as a beneficiary could not withstand a Motion to Dismiss. The fact that the Fiscal Court might have recovered against the bond as

the owner of the Project, had it not entered into an Agreed Order of Dismissal, is irrelevant to the question of whether the School Board could have recovered under any circumstances against the bond as a beneficiary thereof.

By responding to USF&G's Motion to Dismiss the original Complaint with a Motion for Leave to Amend the Complaint, the School Board tacitly acknowledged that its original Complaint was deficient. Consequently, the District Court was correct in dismissing the School Board's original Complaint against USF&G.

ARGUMENT III

THE DISTRICT COURT WAS CORRECT IN DENYING THE SCHOOL BOARD LEAVE TO AMEND.

As one of its four allegations of error, the School Board complains that the District Court erred in overruling its Motion for Leave to File an Amended Complaint. This issue was the only real substantive issue before the District Court and the Court of Appeals, and when the School Board's Petition is trimmed of superfluous argument, it is the only substantive issue on its Petition for Writ of Certiorari.

A.

THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN DENYING THE SCHOOL BOARD LEAVE TO AMEND.

When the parties to the action on the contract between Diniaco and the Fiscal Court dismissed that suit with prejudice without a finding of a default under the

contract by Diniaco, the School Board quickly realized that its original Complaint in this action could not withstand a Motion to Dismiss. When USF&G filed its Motion to Dismiss the Complaint, the School Board responded with a Motion for Leave to File an Amended Complaint in order to assert a cause of action based upon the doctrine of equitable subrogation, a doctrine which has been widely discredited and which the Kentucky courts have strictly limited in application. *United Pacific Insurance Company v. First National Bank*, Ky., 457 S.W.2d 833, 835 (1970).

Federal Rule of Civil Procedure 15(a) provides that leave to file an amended complaint "shall be freely given when justice so requires." Whether a party should be granted leave to amend a complaint is a matter within the sole discretion of the District Court, and the District Court's decision is reversible only in the case of abuse of discretion. *United States v. Wood*, 877 F.2d 453, 456 (6th Cir. 1989). In the instant case, justice did not require that leave to amend be granted, and the District Court did not abuse its discretion in refusing to permit the School Board to amend its Complaint.

Equitable subrogation, the doctrine on which the School Board seeks to hang its claim for recovery, is a creature of equity. *National Surety Corporation v. Allen-Codell Co.*, 70 F. Supp. 189, 191 (E.D. Ky. 1947). The Kentucky courts have referred to the doctrine of equitable subrogation as "pure equity, having foundation in principles of natural justice." *Vance v. Atherton*, 252 Ky. 591, 67 S.W.2d 968, 970 (1934). As such, application of the doctrine of equitable subrogation is subject to the discretion

of the court. *Western Casualty & Surety Co. v. Meyer*, 301 Ky. 487, 192 S.W.2d 388, 391 (1946).

> When a litigant selects an equitable remedy, he necessarily submits the enforcement of his rights to the traditional discretionary powers of equity.

W.T. Grant Co. v. Indian Trail Trading Post, Inc., Ky., 438 S.W.2d 91, 92 (1968). As a general principle, in both state and federal court, whether equitable relief will be granted rests in the sound discretion of the trial court. *Petroleum Exploration, Inc. v. Public Service Commission of Kentucky*, 304 U.S. 209, 218 (1938).

In denying the School Board's request for leave to amend, the District Court specifically found that permitting the School Board to amend its Complaint to assert a cause of action based upon equitable subrogation "would be inconsistent and unjust." (Memorandum Opinion and Order, Appendix Page 1). In support of its finding that equity was not on the side of the School Board, the District Court offered the following discussion:

> Furthermore, in exercising its discretion not to invoke the equitable remedy of subrogation, the Court notes that the School Board ardently disclaimed any ownership interest in the high school in the other lawsuit involving the disputes under the construction contract. Throughout the proceedings of Ashland Civil Action Number 86-107 [the action on the contract], the School Board maintained that it was not a party to the construction contract, that it bore no responsibility for the problems with the project, and that Diniaco, the prime contractor, dealt with it "at its own peril."

> Diniaco had attempted to show substantial breaches of the construction contract by the School Board, however this Court granted the School Board's Motion to Dismiss finding that the School Board was not a party to the construction contract nor in sufficient privity with the Fiscal Court to justify a breach of contract action against the School Board.
>
> For the School Board to sit out the contest of responsibility, denying its identity as the Owner, and then be permitted to claim the status of a beneficiary under the Performance and Payment Bond executed for the benefit of the owner and suppliers of labor and materials would be inconsistent and unjust. The sword must cut both ways with equity.

(App. 8 & 9).

The School Board now complains that the District Court erred in determining, on a motion to amend, that the equities did not favor granting the School Board leave to amend. The same District Court presided over the litigation in both the action on the contract and this action on the bond. The District Court was well acquainted with all of the parties and their respective positions. As such, the District Court was in the best position to balance the equities of the parties, and the Court, within its discretion, specifically found that the balance of equity did not tip in favor of the School Board. These issues were thoroughly briefed to the District Court, and the District Court did not abuse its discretion in concluding that justice did not require permitting the School Board to amend its Complaint to seek equitable relief. Fed. R. Civ. P. 15(a); *Petroleum Exploration, Inc. v. Public Service Commission of Kentucky*, 304 U.S. at 218.

B.

THE SCHOOL BOARD IS NOT ENTITLED TO ASSERT A CLAIM BASED UPON THE THEORY OF EQUITABLE SUBROGATION.

The School Board alleged in its tendered Amended Complaint that it advanced approximately $725,000.00 to the Fiscal Court's construction fund in order to allow the Project to be completed after the dispute between Diniaco and the Fiscal Court arose. The School Board's alleged advancement of monies to the construction fund was used to make up for a claimed short-fall in funding caused by the Fiscal Court's engagement of a new general contractor, together with new sub-contractors, at a substantially higher cost than the contract between the Fiscal Court and Diniaco.

By its tendered Amended Complaint, the School Board sought to recover the monies it allegedly advanced to the Fiscal Court's construction fund. Because the School Board was neither a beneficiary nor the owner under the USF&G bond as previously discussed, it sought recovery on principles of equitable subrogation. The School Board made the following argument in the lower courts: First, that those sub-contractors who supplied materials and labor under the contract between the Fiscal Court and the new general contractor hired by the Fiscal Court after Diniaco ceased work were beneficiaries under the USF&G bond; second, that those sub-contractors had a cause of action against Diniaco and USF&G; and third, that by the School Board's advancement of monies to the Fiscal Court's construction fund, monies which ultimately paid the sub-contractors who supplied labor and materials under the new contract between the Fiscal

Court and the new general contractor, the School Board became equitably subrogated to the rights of those subcontractors as against Diniaco and USF&G. The School Board's theory is fatally flawed in that it does not satisfy the specific requirements of equitable subrogation.

In order for a party to recover on grounds of equitable subrogation, (1) it must have paid the debt of another, and (2) it must not be a volunteer in its payment. *Bryan v. Henderson Electric Company*, Ky. App., 566 S.W.2d 823, 825 (1978). A party seeking the relief of equitable subrogation must show a strong and clear case for its application. *National Surety Corporation v. Allen-Codell Co.*, 70 F. Supp. at 192. The Kentucky Court has noted that the right to equitable subrogation "hangs by a most tenuous thread," and that the doctrine "cannot be used as a universal remedy for parties who have lost their money." *York v. Cline Construction Co.*, Ky., 336 S.W.2d 234, 38 (1960).

Not only did the District Court find that the equities of the case did not warrant granting the School Board leave to amend, but the Amended Complaint tendered by the School Board failed to state a claim upon which relief could be granted. First, the School Board was clearly a volunteer in its advancement of monies to the Fiscal Court's construction fund. Second, those whose rights the School Board claims to be subrogated to were not protected by the USF&G bond.

1. The School Board's Contribution of Money to the Fiscal Court's Construction Fund Was Voluntary.

One who, under no legal obligation to do so, volunteers to pay the debt of another is not entitled to invoke

the doctrine of equitable subrogation. *Vance v. Atherton*, 67 S.W.2d at 970; *City of Jackson v. First National Bank of Jackson*, 289 Ky. 1, 157 S.W.2d 321, 326 (1941). The District Court specifically found that the School Board was under no legal obligation to take monies from other accounts and deposit them into the Fiscal Court's construction fund. The Court noted that the School Board pointed out "a host of practical considerations" but that those did not equate to a legal obligation. (App. 8). As previously discussed, the Court specifically reasoned that the School Board "ardently disclaimed any ownership interests in the high school" in the action on the contract and that the School Board was not "in sufficient privity with the Fiscal Court." (App. 8 & 9). The District Court, within its discretion, concluded that the School Board was a volunteer in making the payment.

The School Board argued at the Sixth Circuit Court of Appeals that it had seven palpable interests which required it to contribute to the Fiscal Court's construction fund. Interestingly, these interests were not so "palpable" to the School Board in the action on the contract as to warrant its participation in that suit. In fact, when called upon in the action on the contract, the School Board disclaimed all interest in the project and claimed that if Diniaco dealt with it, Diniaco did so "at its own peril." (App. 8). As concluded by the District Court, for the School Board to sit out the contest of responsibility by disclaiming all interest in the project and now be permitted to assert those previously disclaimed interests in an effort of recover on Diniaco's bond " . . . would be inconsistent and unjust." (App. 9). The interests asserted

by the School Board were neither palpable nor legal in the action on the contract, nor are they in the present action before this Court.

The District Court did not abuse its discretion in concluding that the School Board was a volunteer in its advancement of monies to the Fiscal Court's construction fund. The School Board is not entitled to the remedy of equitable subrogation simply to correct its mistake of voluntarily paying too much for a project it did not own.

2. The New Suppliers of Labor and Materials to Whose Rights the School Board Claims to be Subrogated Are Not Protected by the USF&G Bond.

The District Court did not adopt that portion of the Magistrate's Report and Recommendation which concluded that the suppliers of labor and materials to whose rights the School Board claims to be subrogated were not beneficiaries of the USF&G bond. Nevertheless, USF&G respectfully submits that the Magistrate's conclusion in this regard was correct and offers further support for the District Court's conclusion that the School Board should not have been permitted to amend its Complaint to assert a claim based upon principles of equitable subrogation. (Appendix B). Those who supplied labor and materials to complete the project did so under a new contract between the Fiscal Court and a new general contractor with a new bond, and thus those laborers and suppliers had no rights under the USF&G bond. Because it is the rights of those suppliers of labor and material to which the School Board

claims to be subrogated, the School Board similarly has no rights or protection under the bond.

The September 5, 1984 bond executed between Diniaco and USF&G guaranteed payment of all claims for labor performed and materials furnished in connection with the performance of "the contract." The bond specifically defined "the contract" as "a certain written contract, dated first day of August, 1984, entered into between the principal [Diniaco] and the owner [Fiscal Court], for the construction of additions and alterations to Boyd County High School, Cannonsburg, Kentucky," The contract referred to in the bond is the contract between Diniaco and the Fiscal Court, not the subsequent contract between the Fiscal Court and the new general contractor.

In short, in order for the School Board to collect under the USF&G bond based upon the principles of equitable subrogation, the School Board must be subrogated to the rights of a beneficiary of that bond. If the School Board might be subrogated to anyone's rights, it would be the rights of those who supplied material and labor in connection with the subsequent contract between the Fiscal Court and the new general contractor. Those persons and firms are not beneficiaries under the USF&G bond because they did not supply labor or materials in connection with the performance of the contract between Diniaco and the Fiscal Court. If those suppliers of labor and materials had not been paid, their claims would have been against the new contractor and the new contractor's bond, not against Diniaco and its bond. Because those persons did not have a right as against Diniaco, the School Board, by allegedly providing funds to pay those

persons to complete the project, likewise does not have a right as against Diniaco or Diniaco's bond with USF&G.

Although the District Court did not concur in the Magistrate's conclusion in this regard and denied the School Board's Motion for Leave to Amend on the basis of equity and the voluntariness of the School Board's alleged contribution to the Fiscal Court's construction fund, the Magistrate's conclusion that those to whose rights the School Board claims to be subrogated were never protected by the USF&G bond was correct and is further support for the District Court's ruling.

ARGUMENT IV

THE DISTRICT COURT'S STAY OF THIS ACTION WAS NOT ERROR AND DID NOT PREJUDICE THE SCHOOL BOARD.

The District Court did not err in ordering that this action be held in abeyance pending the resolution of the action on the contract. The District Court was faced with two actions involving substantially the same subject matter. The action on the contract was initiated by Diniaco against the Fiscal Court and the School Board, with a counterclaim against Diniaco. The action on the bond was initiated by the Fiscal Court and the School Board against USF&G. Both actions concerned the failure of the construction Project and which of the parties caused the delays.

The School Board and the Fiscal Court sought to consolidate the action on the contract with the action on the bond. USF&G opposed the Motion to Consolidate primarily because the parties were not identical, i.e.

USF&G was a party to the action on the bond but not to the action on the contract, and Diniaco was a party to the action on the contract but not to the action on the bond. USF&G requested the District Court to hold this action on the bond in abeyance pending the outcome of the liability issues to be tried in the action on the contract because USF&G's liability on the bond necessarily depended upon a finding, in one action or the other, that Diniaco had defaulted on the construction contract. For whatever reason, the District Court determined that it would be unwise to consolidate the two actions, but chose instead to hold this action on the bond in abeyance pending the outcome of the action on the contract. The District Court's decision was not error.

The District Court must be permitted to exercise some degree of control over its docket. As the District Court had determined that consolidation of the two actions would be unwise, permitting both cases to proceed to trial to determine which of the parties to the construction contract was at fault would have been a substantial waste of judicial time. Holding one of the actions in abeyance pending the outcome of the other was the only logical option, and as the action on the contract involved those who were actual parties to the construction contract, the best choice was to hold the action on the bond in abeyance. Such Orders involving the supervision of litigation are reversible only for an abuse of discretion, and it is clear that the District Court's decision to hold the action on the bond in abeyance pending the outcome of the action on the contract was not an abuse of discretion. *Pierce v. Underwood*, 487 U.S. 552, 559, n.1 (1988).

Regardless of whether the District Court was correct in holding this action in abeyance pending the outcome of the action on the contract, the decision to do so did not prejudice the School Board. As previously discussed, the School Board's original Complaint against USF&G could not withstand a Motion to Dismiss either at the time it was filed or later. The School Board was never a beneficiary of the bond, and it disclaimed all ownership in the Project.

Similarly, holding this action in abeyance did not affect the School Board's ability to amend its Complaint to seek recovery under the doctrine of equitable subrogation. The two primary facts causing the District Court to deny the School Board's Motion for Leave to Amend the Complaint had already occurred and were known to the Court when the Court decided to hold this action in abeyance, and nothing occurring after the Order holding this action in abeyance changed those two facts. The first was the School Board's voluntary contribution of monies to the Fiscal Court's construction fund. The second was the School Board's adamant denial of any ownership interest in the Project in the action on the contract. As a result of its arguments that it was not an owner of the Project, the School Board was dismissed as a party to the action on the contract in September of 1986, approximately eight (8) months prior to the Order holding this action in abeyance. Finally, the School Board could never have been successful in stating a claim for relief based upon equitable subrogation because, as previously discussed, the School Board was seeking to be subrogated to the rights of individuals who had no rights against the USF&G bond.

In short, although the School Board now complains that the District Court's Order in holding this case in abeyance pending the outcome of the action on the contract prejudiced it, nothing occurred after the Order that changed the rights of the School Board as asserted by its original Complaint and its tendered Amended Complaint. Simply stated, neither the original Complaint, nor the tendered Amended Complaint, could withstand a Motion to Dismiss, regardless of what might have occurred after the Order holding this action in abeyance. In summary, the District Court's decision to hold this action in abeyance was not error and did not prejudice any rights of the School Board.

ARGUMENT V

THE COURT OF APPEALS COMMITTED NO ERROR IN AFFIRMING THE DECISION OF THE DISTRICT COURT WITHOUT LENGTHY OPINION.

For its final assertion of error, the School Board complains that the Court of Appeals improperly affirmed the decision of the District Court at least in part because it failed to write a lengthy opinion, or as the School Board claims it "affirmed without opinion". (Petition, p. 6). In fact, the Court of Appeals filed a per curiam opinion affirming the District Court for the reasons set forth in the District Court's Memorandum Opinion and Order.

In support of its argument that the Court of Appeals' method of affirming the District Court was erroneous, the School Board cites *Salve Regina College v. Russell*, 499 U.S. ___, 111 S. Ct. 1217, 113 L. Ed.2d 190 (1991). The issue in *Russell* was whether a Court of Appeals should review de

novo a District Court's determination of state law. The case had nothing to do with the propriety of the Court of Appeals affirming a decision of a District Court without opinion or with only a brief per curiam opinion. The most applicable portion of the *Russell* Opinion requires appellate courts to give "a careful consideration of the district court's legal analysis". *Russell,* 113 L. Ed. 2d at 198. A review of the Court of Appeals per curiam Opinion in this case reveals that the Court of Appeals followed that directive:

> Having *carefully considered the record* and the arguments presented in the briefs and orally, we find no error warranting reversal. [Emphasis added].

(Appendix Page C).

Finally, Rule 36 of the Federal Rules of Appellate Procedure specifically contemplates judgments of the Court of Appeals without opinion.

Even if the Court of Appeals' method of affirming the District Court could be considered error, certainly it is not the type of error which would justify this Court's intervention.

CONCLUSION

Because the District Court and the Court of Appeals were correct in their judgments, USF&G respectfully requests this Court to deny the Petition for a Writ of Certiorari.

Respectfully submitted,

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APPENDIX A

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY ASHLAND

CIVIL ACTION NO. 87-72

BOYD COUNTY BOARD OF EDUCATION,
PLAINTIFF,

V. **MEMORANDUM OPINION AND ORDER**

UNITED STATES FIDELITY
& GUARANTY COMPANY, DEFENDANT.

* * *

This matter is before the Court upon the motion of defendant to dismiss this action and upon the motion of plaintiff to amend its complaint. The parties have filed various memoranda briefing the issues raised in the motions. The Magistrate filed a Report and Recommendation advising denial of plaintiff's motion to amend its complaint, granting of defendant's motion to dismiss, and dismissal of this action. The plaintiff has filed objections to the Magistrate's Report and Recommendation to which the defendant has filed a response.

BACKGROUND

Diniaco & Sons, Inc. ["Diniaco"], a general contractor, originally contracted with the Boyd County Fiscal Court ["Fiscal Court"] for construction of additions and improvements to the Boyd County High School. The Fiscal Court is the owner of the school property and raised money for the project by issuing school building revenue bonds. The revenue was placed in a school construction account. Diniaco, the Fiscal Court and the defendant,

United States Fidelity & Guaranty Company ["USF&G"], executed a performance and payment bond before commencement of the work.

After a dispute developed, Diniaco left the job and refused to return. The Fiscal Court then negotiated with another contractor for completion of the project. At this point, the Boyd County Board of Education ["School Board"] took money from other accounts and deposited $725,467.80 into the school construction account. The project was subsequently completed, of which $725,087.32 was utilized from the school construction account for the completion.

Diniaco filed suit against the Fiscal Court and the School Board for breach of the construction contract.[1] The Fiscal Court filed a counterclaim alleging Diniaco breached the contract. In that action this Court held the School Board was not a party to the construction contract, thus this Court dismissed the School Board as a party from the suit. That action was eventually settled between Diniaco and the Fiscal Court, among others, and the action was dismissed with prejudice on May 17, 1989.

As a result of the circumstances regarding the construction of the high school, the Fiscal Court and the School Board initiated this action against the surety, USF&G, on the performance and payment bond for the additional expenses incurred in completing the project with a different contractor. Pursuant to agreement of the parties, the Fiscal Court has been dismissed as a party plaintiff. Therefore, only the School Board is currently

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[1] Civil Action No. 86-107, Ashland Division.

asserting a claim against USF&G on the performance and payment bond.

DISCUSSION

A. Extent of Coverage Under the Bond

USF&G has filed a motion to dismiss this action. As grounds for the motion, it argues that the School Board cannot maintain an action on the bond because the School Board was not a contracting party to either the bond or the underlying construction contract. In response, the School Board seeks to amend its complaint to allege "equitable subrogation." In other words, the School Board, by paying sums to the various laborers and materialmen to complete the project, contends it is entitled to stand in the shoes of the laborers and materialmen to assert a claim against the performance and payment bond.

In his Report and Recommendation, the Magistrate first concluded that the terms of the bond only name the Fiscal Court as a beneficiary, and does not allow those who did not contract with the original contractor, Diniaco, to constitute beneficiaries under the bond. The Magistrate found that the School Board's "claim" is not a claim for labor performed or material furnished in connection with the performance of the contract *between Diniaco and the Fiscal Court.* The monies advanced by the School Board were used to pay for labor performed and materials furnished in connection with the new contract *between the Fiscal Court and a new contractor.* Therefore, the School Board cannot be a third party beneficiary under the USF&G bond. Thus, the Magistrate concluded that

only those subcontractors that performed labor or supplied materials in connection with the contract *between Diniaco and the Fiscal Court* may be third party beneficiaries under the USF&G bond.

However, a reading of the bond itself suggests otherwise. The bond terms allow the Owner to pursue claims for all cost incurred due to the failure of Diniaco to complete the project:

> [W]e . . . Phillip Diniaco & Sons, Inc., . . . as Principal, and . . . United States Fidelity and Guaranty Company, . . . as Surety, are held and firmly bound unto the . . . Boyd County Fiscal Court, . . . hereinafter called the Owner, in the penal sum of Three Million Two Hundred Eighteen Thousand DOLLARS ($3,218,000.00) for the payment of which we bind ourselves, our heirs, executors, administrators, successors, and assigns for the faithful performance of a certain written contract, dated 1st day of August, 1984, entered into between the Principal and the Owner, for the construction of . . . Additions and alterations to Boyd County High School, Cannonsburg, Kentucky. . . .
>
> NOW THEREFORE, the conditions of this obligation is [sic] such that if the Principal shall faithfully perform the terms and conditions of the contract in all respects on their part, and shall pay all obligations incurred in connection therewith, all such other obligations of every form, nature and character, and shall save harmless, the Owner from all and any liability of every nature, kind and character which may be incurred in connection with the performance or fulfillment of such contract or other such liability resulting from negligence or otherwise on the part of such Principal and further shall save harmless the Owner from *all costs and damage*

> *which may be suffered by reason of the failure to fully and complete perform said contract* and shall fully reimburse and repay the Owner for all expenditures of every kind, character and description which may exist on the party of the Principal in connection with the performance of said contract, and further that the Principal shall pay all lawful claims of all persons, firms, partnerships or corporations for labor performed . . . and material furnished in connection with the performance of the contract, and that the failure to do so with such persons, firms[,] partnerships or corporations shall give them direct right of action against the Principal and Surety under the obligation . . .

PERFORMANCE AND PAYMENT BOND, at 1 (emphasis added).

Thus, this Court concludes that the bond itself does provide for recovery of damages associated with Diniaco's failure to complete the project, *including those damages stemming from hiring a new contractor to complete the project*. In addition, Section 19 of the general conditions of the construction contract provides that if the original contractor, Diniaco, fails to complete the work then, after various notices, the owner "may without prejudice complete the work." That obviously happened in the present case. The Fiscal Court retained new contractors to complete the high school project. Thus, these new contractors are fully entitled to the protection of the performance and payment bond to meet this very contingency.

It is implausible to conclude that the bond security performance ends upon default by Diniaco. The prime

contractor cannot cancel the payment bond by abandoning the project. There is simply no distinction in the coverage of the bond between those suppliers hired by the original contractor and those who separately contract to complete the project after default. The clear meaning of the bond terms requires this result. This bond is required by the Kentucky Education Department and is a *project* bond, and the obligees are not limited to people hired by the original prime contractor.

Thus, the Fiscal Court as owner of the project had a contractual right to assert a claim against the surety or damages associated with Diniaco's failure to complete the project. The new contractors had a right to seek payment from the Fiscal Court as owner, and the Fiscal Court had a right to pursue claims against Diniaco and the Surety. However, the Fiscal Court settled its claims against Diniaco in its counterclaim in the other action. In any event, by agreement of the parties the Fiscal Court has been dismissed as a party plaintiff in this action. Therefore, the Fiscal Court is not asserting any claim against the surety for additional amounts expended due to Diniaco's failure of performance. The Court now turns to the School Board's assertion of equitable subrogation.

B. The Doctrine of Equitable Subrogation

The issue posed is whether the School Board can be subrogated to the position of the laborers and materialmen, or even to the position of the Fiscal Court, in the bond contract to assert a claim for the monies placed in the school construction account and expended to complete the project. This issue centers on the School Board's

motion to amend its complaint to assert application of the doctrine of equitable subrogation. In this regard, the Magistrate also concluded in his Report and Recommendation that, even assuming later suppliers and laborers hired to complete the project were entitled to protection under the bond, the School Board is not entitled to assert equitable subrogation. The Magistrate found the School Board was a "volunteer" as a matter of law in contributing funds to complete the project, thus barring its claim of equitable subrogation.

The equitable principle of subrogation is also referred to as "legal subrogation." According to Kentucky courts, entitlement to subrogation revolves upon consideration of five factors:

1) payment by one of the debt of another;
2) subrogee is not a volunteer;
3) the debt is not one for which the subrogee is primarily liable;
4) the entire debt must be paid unless the others who made payment are joined; and
5) subrogation must not work any injustice to the rights of others.

Bryan v. Henderson Elec. Co., 566 S.W.2d 823, 825 (Ky.App. 1978).

The Kentucky high court has strictly limited application of equitable subrogation. *United Pac. Ins. Co. v. First Nat'l Bank*, 457 S.W.2d 833, 835 (Ky. 1970); *York v. Cline Constr. Co.*, 336 S.W.2d 34, 37 (Ky. 1960). The doctrine "cannot be used as a universal remedy for parties who have lost their money." Id at 38. Subrogation is an equitable remedy, and "[i]n the award of equitable remedies

there is normally an element of great discretion." *W. Casualty & Sur. Co. v. Meyer*, 301 Ky. 487, 493, 192 S.W.2d 388 (1946).

The most pertinent element to this action is the requirement that the subrogee not be a volunteer. "An interloper or a volunteer who, with no legal obligation to do so, pays the debt of another, is not entitled to invoke the equitable doctrine of subrogation." *Vance v. Atherton*, 252 Ky. 591, 594, 67 S.W.2d 968 (1934). This Court agrees with the Magistrate that the School Board is a "volunteer" and therefore not entitled to assert subrogation as a matter of law.

The School Board was under no legal obligation to make monies from other accounts and deposit them into the school construction account. Although counsel for the School Board points to a host of practical considerations that led the Board to expend the sums to complete the school project, these do not equate to a legal obligation.

Furthermore, in exercising its discretion not to invoke the equitable remedy of subrogation, the Court notes that the School Board ardently disclaimed any ownership interests in the high school in the other lawsuit involving the disputes under the construction contract. Throughout the proceedings of Ashland Civil Action Number 86-107, the School Board maintained that it was not a party to the construction contract, that it bore no responsibility for the problems with the project, and that Diniaco, the prime contractor, dealt with it "at its own peril".

Diniaco had attempted to show substantial breaches of the construction contract by the School Board, however, this Court granted the School Board's motion to dismiss finding that the School Board was not a party to the construction contract nor in sufficient privity with the Fiscal Court to justify a breach of contract action against the School Board.

For the School Board to sit out the context of responsibility, denying its identity as the Owner, and then be permitted to claim the status of a beneficiary under the performance and payment bond executed for the benefit of the owner and suppliers of labor and materials would be inconsistent and unjust. The sword must cut both ways with equity.

Therefore, the School Board's voluntary payment of funds to the laborers and materialmen for completion of the high school voids its attempt at assertion of subrogation. Furthermore, the conflicting stances of the School Board as to its posture in this matter leads the Court to view less need for the requested equity.

The Plaintiff argues that whether it constitutes a "volunteer" is a question of fact for the jury. This Court disagrees. The subrogation remedy is one of equity. Courts, not juries, determine whether equity applies in a given circumstance. Although there are fact issues that juries may consider regarding equitable claims, the issue of whether the plaintiff is entitled to assert the doctrine in the first instance is a question of law. This Court concludes that the plaintiff has not sufficiently shown entitlement to the doctrine of equitable subrogation as a matter

of law. Since the plaintiff is not entitled to assert equitable subrogation, there is no need to amend its complaint.

Therefore, it is hereby ORDERED:

1) that the plaintiff's objections to the Magistrate's Report and Recommendation are GRANTED as to the extent of coverage under the performance and payment bond;

2) that the plaintiff's objections to the Magistrate's Report and Recommendation are DENIED as to the doctrine of equitable subrogation and as to the plaintiff's motion to amend its complaint;

3) that the plaintiff's motion to amend its complaint is DENIED;

4) that the defendant's motion to dismiss is GRANTED and this matter is DISMISSED WITH PREJUDICE at the plaintiffs' costs; and

5) that this matter is STRICKEN from the active docket. This 26th day of April, 1990.

/s/ _____
KARL S. FORESTER, JUDGE

Date of Entry and Service:

APPENDIX B

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
ASHLAND

CIVIL ACTION NO. 87-72

BOYD COUNTY BOARD OF EDUCATION, PLAINTIFF

VS.

MAGISTRATE'S REPORT AND RECOMMENDATION

FILED MAR 13 1990

UNITED STATES FIDELITY & GUARANTY COMPANY, DEFENDANT

This is a diversity action for breach of contract based on a performance and payment bond issued by United States Fidelity & Guaranty Company [USF&G] to the Boyd Fiscal Court insuring the performance of a contract for the construction of additions and alterations at the Boyd County High School. The matter was referred to the undersigned for a hearing, held January 19, 1990, and a report and recommendation on pending motions to dismiss the complaint and to amend the complaint. 28 U.S.C. § 636(b)(1)(B).

The remaining plaintiff in this matter is the Boyd County Board of Education [Board]. [Record No. 22]. In its motion to dismiss, USF&G argues: (1) that the Board is not a proper party because it was not a beneficiary under the performance and payment bond; and (2) that action on the bond is precluded by Boyd County's dismissal of claims against the construction contractor.

In response to this motion, the Board moved to amend its complaint to state claim under the doctrine of

"equitable subrogation", arguing that, by advancing funds for completion the project, it is [sic] has stepped into position of materialmen and suppliers entitled to payment under the bond. The plaintiff also asserts that, under existing case law, relief under the bond does not required [sic] a preceding judgment against the contractor. USF&G replies that "equitable subrogation" is unavailable because the Board volunteered the funds, and because those funds paid no debt of the original contractor.

The original construction contract in this matter was between the Boyd County Fiscal Court [County] and contractor Phillip Diniaco & Sons, Inc. [Diniaco].[1] For bond financing purposes, the property had been deeded by the Board to the County and then leased back to the Board. As part of the construction project, the a [sic] performance and payment bond was executed. The contractor did not complete the project, forcing the County to hire new suppliers. The construction was then completed, but at a higher cost than was covered by the bond financing. The Board advanced $725,087.32 to the County for payment of the suppliers completing the project.

The defendant points out that the Board is not a party to the performance bond and, thus, it is not entitled to recover directly thereunder. The defendant is correct on this point and, by its motion to amend the complaint, the Board also appears to recognize the fact. The Board, instead, attempts to inject itself as a beneficiary to the

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[1] The County has been dismissed as a plaintiff in this action. [Record No. 22].

bond by asserting that its advancement of funds has the effect of subrogating it to the rights of those entitled to recover under the bond for supplying labor and materials in the eventual completion of the project.

The plaintiff is mistaken as to the rights of the suppliers after the breach of the original contractor. The Board believes that, under the terms of the payment bond, suppliers who are hired to complete a project after nonperformance by the principal to the bond (the original contractor) are entitled to payment by the principal or the bond surety. There is, however, a distinction in the coverage of the bond between those suppliers hired by the original contractor and those who separately contract to complete the project after default.

The Board states in its tendered amended complaint that the default by Diniaco forced the "engagement of *other* construction concerns and suppliers to complete the project." [Record No. 11 at 2 (emphasis added)]. Those "other" suppliers clearly do not have a contract with Diniaco, as is required under the standard payment bond. [Record No. 14, Exhibit (emphasis added)]. The Board contends that the terms of payment bonds approved by the Kentucky Department of Education are more broad, securing payment of *"all* lawful claims of *all* persons, firms, partnerships, or corporations for labor performed . . . and material furnished in connection with the performance of the contract." [Record No. 11, Exhibit 1 (emphasis added)].

The Board believes this language binds the defaulting principal contractor and the original surety to pay every claim for every party which works on the project,

regardless of how and by whom that party was employed. This, of course, is too broad a reading of the bond terms. The Board ignores the latter portion of the quoted sentence from the bond, clearly limiting coverage to suppliers for performance of "the contract". The "contract" can only be that between the original principal contractor on the bond and the owner of the project. That contract, unless otherwise provided, ends upon default. Those suppliers engaged separately by the owner or a later contractor are performing under a different contract and one which the bond is not meant to reach.

A different interpretation of the bond terms would leave wide open a situation for abuse. The owner would be given carte blanche to hire new suppliers regardless of expense, and then to charge that additional cost to the defaulting contractor or the surety. The payment bond simply insures that suppliers to a defaulting contractor are not left hanging when that contractor walks away from the project. The engagement of new suppliers to complete the project should, in theory, cost no more than the owner would have paid anyway. To the extent that additional expense results, the payment bond is not applicable to those overruns and relief must be sought elsewhere.

Although the Board presents a compelling argument for equity in this circumstance, it is obvious that the debt paid by the Board must have been one which was to be covered under the terms of the payment bond. In this case, the pleadings do not support such a finding. Thus, the specific terms of the payment bond preclude the Board's subrogation argument.

Assuming those suppliers were entitled to recover under the bond, the Board's argument is inconsistent with the requirement that its payment of the debt not be "voluntary". *Vance v. Atherton*, 67 S.W.2d 968, 970 (Ky. 1934). If the suppliers paid by the Board were entitled to full payment under the bond, the Board clearly was a volunteer in contributing to those suppliers. Although the Board may, in such a circumstance, have felt some moral or practical compulsion to simplify the process and present the suppliers' claims to the surety, it was under no *legal obligation* to do so. Absent such a duty, the doctrine of equitable subrogation does not apply. Amendment of the complaint to add such a claim would be futile.

Accordingly, the undersigned recommends that the plaintiff's motion to amend its complaint be denied and that the defendant's motion to dismiss the complaint be granted.

Particularized objections to this Report and Recommendation must be filed within ten (10) days of the date of service of the same or further appeal is waived. *Thomas v. Arn*, 728 F.2d 813 (6th Cir. 1984), *aff'd*, 474 U.S. 140 (1985); *Wright v. Holbrook*, 794 F.2d 1152, 1154-55 (6th Cir. 1986). A party may file a response to another party's objections within ten (10) days after being served with a copy thereof. Rule 72(b), Fed. R. Civ. P.

This the 13th day of March, 1990.

/s/ Joseph M. Hood
JOSEPH M. HOOD
United States
Magistrate

Date of Entry and Service: MAR 14 1990

APPENDIX C

NOT FOR PUBLICATION

90-5684

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BOYD COUNTY BOARD OF EDUCATION, Plaintiff-Appellant, v. UNITED STATES FIDELITY & GUARANTY CO., Defendant-Appellee.	)	On Appeal from the United States District Court for the Eastern District of Kentucky. FILED FEB 26 1991

BEFORE: KEITH and KRUPANSKY, Circuit Judges; and ENGEL, Senior Circuit Judge.

PER CURIAM: The Boyd County Board of Education appeals from the district court's April 26, 1990, Memorandum Opinion and Order granting United States Fidelity & Guaranty Company's motion to dismiss.

Having carefully considered the record and the arguments presented in the briefs and orally, we find no error warranting reversal. Therefore, we **AFFIRM** the order of the Honorable Karl S. Forester, United States District Judge for Eastern District of Kentucky, for the reasons set forth in his Memorandum Opinion and Order.